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A SPECIAL REPORT
ON THE ATTORNEY GENERAL'S RESPONSE
TO THE HOME IMPROVEMENT AND MORTGAGE SCAMS
IN MASSACHUSETTS:
ENFORCEMENT, LEGISLATION AND REGULATION

OCTOBER 1992

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October 30, 1992

A Letter from the Attorney General

To Whom It May Concern:

During the last 18 months, my office has undertaken a comprehensive program of enforcement, and regulatory and legislative action to address the consumer harm resulting from unscrupulous lenders and home improvement mortgage contractors. Investigations by my office showed that vulnerable homeowners -- many of them elderly, minority and inner city residents -- were targeted by certain brokers, lenders and contractors, to take out second mortgages with unconscionable terms and conditions. The most decisive factor for these lenders was whether the consumer had sufficient equity in his or her home to cover the loan in case of default. In many cases, irresponsible lenders gave scant attention to whether consumers could repay their loans with their monthly income. As a result, these consumers were laden with unmanageable debt and, in numerous cases, lost their homes through foreclosures.

Following complaints received by my office, I mobilized a Home Improvement and Mortgage Task Force to take swift action on a variety of fronts to end this insidious form of urban <u>economic</u> violence, in this case blatant victimization of vulnerable homeowners.

This report describes the origins of the second mortgage lending scams, the nature of the illegal activities that took place, the actions my office took to remedy those problems and, most importantly, how to prevent these scandals from happening again.

Some of the major highlights, finding and recommendations of the Task Force are:

* The Home Improvement and Mortgage Task Force has initiated 13 enforcement actions in the last year. These actions have already produced more than $40 million in legally enforceable benefits to Massachusetts consumers, particularly consumers of low and moderate income. More than 1,000 families will be assisted by settlements already reached.

* Unprecedented and creative regulations have been promulgated to curb future abuses, and new mortgage licensing and home improvement laws have been enacted to legislate positive change.

* The widespread home improvement and mortgage scams apparently are primarily the by-product of greed and of the failure of numerous Massachusetts institutions.

* Large financial institutions failed to police their own industry; community organizations and educational institutions and agencies failed to regulate adequately abuse by home improvement contractors and lenders.

* Greater community access to the services of respected financial institutions is required.

* More diligent monitoring of financial abuses must be a priority for the mainstream financial institutions and for regulatory agencies.

* Extensive educational efforts to advance consumer understanding of financial transactions are also required.

I am proud of the success of the Task Force, which consisted of attorneys, investigators and support staff, whose commitment, skill and dedication made this all possible. The Task Force enforcement actions will provide relief for thousands of victims and hopefully prevent the tragedies which occurred from being repeated in the future.

I welcome your comments and suggestions on this report and important issue. It is only through working together in partnership that we will be able to protect those in society who need it the most and prevent victimization before it occurs.

Sincerely,

Scott Harshbarger

Table of Contents

I. Introduction

In recent years, across cities and towns in Massachusetts, a familiar sequence of events took place: inner city and suburban homeowners, who were income poor, but had considerable equity in their homes, were targeted to enter into high interest rate mortgage loan transactions, often with unconscionable terms and conditions attached. The irresponsible lenders who preyed on these vulnerable consumers were interested primarily in the equity that these homeowners had built up in their homes, rather than whether consumers could repay the loans with their monthly income.

In hundreds of cases, when consumers could no longer repay these second mortgages, lenders foreclosed on the family home and entire families were evicted.

As homeowners are foreclosed upon, the social fabric of a community is torn apart and the community is destabilized. Destabilized communities are breeding grounds for further forms of economic and other types of urban violence.

Over the past 18 months, the Office of the Attorney General has been investigating and prosecuting unscrupulous lenders, brokers and contractors who engaged in home improvement or second mortgage schemes in an effort to steal the homes of consumers. This work has been largely undertaken by the Home Improvement and Mortgage Task Force which Attorney General Harshbarger created in July, 1991, by drawing upon the resources of numerous divisions within his office. Prior to taking any formal legal action, the Task Force issued dozens of subpoenas, interviewed hundreds of consumers and sought the

advice of various banking and lending industry experts. The actions that were eventually taken by the Task Force were based on a careful assessment of the facts and the law that was part of the exhaustive investigation.

This report is intended to alert individuals, homeowners, community organizations, regulatory and law enforcement agencies and our major financial institutions to the various scams that the Office of the Attorney General investigated and brought to light and that can be so destructive to families and whole communities.

II. Background -- Setting for the Problem

During the 1980's, the Massachusetts real estate market experienced unprecedented growth. Property values skyrocketed, and individuals who had purchased properties in the 1960's and 1970's saw the equity in their property increase dramatically.

During this period, scams emerged that were designed to persuade homeowners to transfer the built-up equity in their homes to lenders, brokers and home improvement salesmen under loan conditions that contained unconscionable terms, or under promises of home improvement repairs that were overpriced, faulty or never took place. Those hardest hit by these scams were the elderly, those already in financial distress, those unsophisticated in financial transactions, communities of color and others, who while income poor or on fixed incomes, had built up significant equity in their homes.

These schemes flourished for a number of reasons. First,

it appears that the only credit available to these consumers was from the then unregulated and unlicensed second mortgage companies and brokers. These lenders and brokers were not able to police themselves sufficiently to prevent economic exploitation by a certain few. This exploitation was aided by unethical brokers who extracted large, unconscionable fees from consumers and who, in some instances, had undisclosed financial and corporate ties to lenders whose primary goal apparently was the acquisition of real estate.

Second, the simple fact is that many inner city communities across this state were abandoned by mainstream lending institutions during the 1970's and 1980's. Even during the economic boom years of the 1980's, little attention was paid to capturing inner city markets, and creating loan products or providing access to banking services to these communities.

Given the void of credit options created by mainstream financial institutions, the unscrupulous contractor and high rate lender entered the picture and marketed their products to vulnerable homeowners. While there was a lack of access to traditional credit products for these consumers, mainstream financial institutions were funding high rate second mortgage lenders and unscrupulous contractors who were selling loans to these communities. Thus, in addition to the law enforcement attack directed toward specific second mortgage lenders and brokers, the Task Force also took a hard look at those mainstream financial institutions that provided lines of credit

to or purchased mortgages from unscrupulous second mortgage lenders.

III. Allegations -- Apparent Scope of Problem

The Task Force uncovered wide-ranging allegations of wrongdoing falling into the categories listed below. Consumers, community organizations and law enforcement agencies should familiarize themselves with the listed scams and be on guard for them in their individual communities.

A. Misrepresenting the Nature of the Transaction

* Informing consumers that they are mortgaging their homes when they actually are deeding them away and merely retaining a right to repurchase the home;

* Misrepresenting the home improvement work to be performed, the price to be paid, the interest rate, the amount of the loan, the monthly payment or other term of the loan; and

* Misrepresenting that a broker is a lender when, in fact, the broker is merely arranging the loan for a fee rather than actually making the loan.

B. Illusory Inducements

* Promises by a home improvement contractor or lender that he will give the consumer a job to help pay off the loan;

* Promises that onerous loan terms will be rewritten in the future, if the consumer just agrees to pay those terms for a brief period;

* Charging a cash fee in return for a promise to find immediate refinancing for a consumer already facing imminent foreclosure when, in fact, nothing is done for the consumer other than taking the fee; and

* Giving consumers lump sum cash payments "to use as they see fit" as part of mortgage loan proceeds disbursements in order to induce consumers to agree to unaffordable loans.

C. Pressure and Coercive Tactics

* Consumers are rushed through the loan documents without an adequate time to read and understand them;

* Consumers are told that no lawyer is needed to assist them;

* Consumers are told that the contractor cannot get funds to begin home improvements until the bank releases funds and that the bank will not release such funds until the consumer signs a completion certificate indicating work is complete even though work has not even begun; and

* The consumer's ability to read loan documents is physically obstructed by the arms of the contractor across loan documents or because loan documents are rolled up, only revealing signature lines.

D. Failure to Disclose Key Elements of Transaction

* Asking consumers to sign incomplete documents missing such key elements as the interest rate, the finance charges and the number of payments;

* Failure to disclose that a mortgage is being taken on the consumer's property to secure the loan; and

* Failing to disclose that a consumer has inadequate income to repay the loan and that default is therefore likely.

E. Forgeries and Falsification

* Forging a consumer's signature to the certificate of completion credit application or other loan document; and

* Falsifying a consumer's income, by use of false or forged tax statements and rent receipts, in order to inflate the consumer's income and thereby arranging loans the consumer cannot afford.

F. Unconscionable or Unaffordable Loan Terms

* Balloon payment requiring consumers to make large payments of principal usually within a year or two of the loan closing;

* Excessively high loan fees, including broker fees, origination fees and late payment fees;

* Escrow and security fund accounts on which the consumer is charged interest but from which the consumer derives no tangible benefit; and

* Excessively high interest rates.

IV. Actions by the Task Force

Attorney General Harshbarger charged the Task Force with initiating a multi-pronged attack on the scams. This included initiating litigation, drafting and supporting legislation, and promulgating regulations.

A. Litigation

The Task Force has initiated 13 actions relating to home improvement and mortgage scams in approximately the last year. These include actions targeting banks, mortgage companies, home improvement companies and individual home improvement salesmen and mortgage company executives. The actions include the following:

1. Bank Settlements

The Task Force has entered into six separate settlement agreements with Boston area banks. These agreements were entered into following receipt by the banks of letters from the Attorney General indicating an intention to file suit, if settlements could not be reached. We were pleased that the banks involved, once they were aware of our commitment to seek effective remedies, chose to negotiate and settle their respective cases, rather than invest the cost and time involved in litigation. The bank settlements include:

a. BayBank Settlement.

In February, 1992, the Attorney General reached agreement with BayBank regarding any liability it may have had in indirectly financing home improvement transactions. Under the terms of the

settlement, BayBank agreed to establish a program to resolve consumer complaints regarding home improvements that BayBank financed indirectly through contractors between November, 1987 and February, 1992. BayBank, in effect, agreed to accept responsibility for any improper conduct by home improvement contractors where BayBank has indirectly financed the work. As part of the settlement, BayBank also agreed to make $5 million in below-market rate home improvement financing available to low income communities and $6 million available for the construction of affordable housing. The Lawyers' Committee for Civil Rights and the NAACP Legal Defense Fund, Inc. also assisted in the case and participated in the settlement.

b. Shawmut Bank Settlement

Attorney General Harshbarger reached a $7 million settlement with Shawmut Bank to resolve the Task Force investigation of Shawmut Bank's role in funding Resource Financial, a second mortgage company sued by the Attorney General. The settlement requires Shawmut to make $5 million in mortgage loans available to low income communities. These loans will have the following extraordinary features: (a) no downpayment required; (b) no closing costs; (c) an interest rate one point below Shawmut's regular rate. The settlement further requires Shawmut to make $2 million in below-market rate home improvement loans available in targeted low income communities. In addition, the agreement requires Shawmut to provide either a new loan or an average of $6,000 in cash to approximately 50 specific Resource borrowers whose loans were funded by Shawmut. The Union

Neighborhood Assistance Corporation provided the Task Force with information regarding certain Resource borrowers who are aided by the settlement and others described below.

c. Fleet Bank Settlement

The Attorney General, in April of this year, reached a settlement with Fleet Bank to resolve its role in funding Resource Financial Group. This settlement requires Fleet to establish a $12 million mortgage program for low income communities. The program will have the same extraordinary features as in the Shawmut settlement. In addition, Fleet agreed to provide new loans or a $6,000 cash payment to each of the approximately 40 Resource borrowers whose loans were funded by Fleet.

d. Quincy Savings Bank

A settlement also was reached with Quincy Savings Bank to resolve claims against Lincoln Trust Company, which merged into Quincy Savings in early 1992 and which also had funded Resource Financial Group. Quincy Savings Bank agreed to provide either a new loan, on very favorable terms, or a $1,250 cash payment to 100 Resource borrowers. As part of the agreement, Quincy Savings also agreed to make $3 million in mortgage money available, again on terms extraordinarily favorable to consumers.

e. South Shore Bank

In June, 1992, the Attorney General settled mortgage related claims with South Shore Bank, which also funded Resource Financial Group. South Shore agreed to provide relief to 367 Resource borrowers. Of this total, 278 Resource borrowers who have already paid off their Resource loans will receive a flat cash payment of

$2,350. An additional 68 Resource borrowers whose loans are still outstanding will receive either the cash or a refinancing of their loan on very favorable terms. The remaining 21 Resource borrowers whose properties are currently held by Resource will either receive cash or a loan to reacquire their homes. Finally, the agreement requires South Shore to donate $150,000 in cash to establish a legal assistance program for consumers facing foreclosure by lenders other than Resource.

f. USTrust Settlement

A sixth and final bank settlement was reached with USTrust to resolve claims regarding its role in indirectly financing home improvement transactions. USTrust agreed to establish an arbitration program for any consumer who has a complaint regarding home improvement loans funded by USTrust. Under the program, a consumer with a valid complaint can obtain up to $1,000 for Truth-in-Lending violations, can have his or her home improvement loans rewritten on favorable terms and can have shoddy home improvement work repaired at no cost, among other types of relief. Several hundred consumers could qualify for the arbitration program. USTrust also agreed to provide a $3 million mortgage program targeting low income communities. Finally, USTrust agreed to make $2 million in below-market rate loans available to minority owned businesses.

2. Mortgage Company Litigation

The Task Force also has initiated litigation directly against a number of mortgage lenders including Seacoast Industries, Resource Financial Group, Inc., the Money Tree, Inc., Rhodes Financial, Inc.,

and State Finance and Mortgage Company of Springfield. Each of these cases is in litigation, although several defendants have announced that they are going out of business in response to the suits.

3. Home Improvement Company Litigation

The Attorney General also has sued a number of home improvement companies, including Seacoast and Carefree Building Products, Pro-Tec-To Rolling Shutters of New England, Inc., and Rolling Shutter Systems of New England, Inc. These suits are pending.

4. Home Improvement Salesmen

The Attorney General also has initiated two separate consumer protection actions against four former salesmen for Vinyl Distributors of New England.

B. New Consumer Protection Regulations

In addition to litigation that will provide relief to consumers for past injuries, the Office of the Attorney General promulgated a comprehensive set of consumer protection regulations that are intended to create a level playing field for all lenders and to protect consumers from future abuses by unscrupulous lenders and brokers. The key features of these unprecedented regulations, which were promulgated following public hearings, include:

* Requiring that all brokers and many lenders provide borrowers with standardized copies of the Attorney General's Mortgage Broker and Lender Disclosure Forms. These forms identify in simple and clear language the essential features of a mortgage loan transaction as well as the cost and interest rate the borrower will have to pay;

* Requiring that lenders and brokers take reasonable steps to assure that borrowers understand the loan transaction. This is an effort to address the needs of non-English speaking borrowers. The regulations recommend the use of

adult interpreters or translated disclosure forms, which will be provided by the Attorney General's office in several languages.

* Prohibiting unconscionable rates or other loan terms. As an example of unconscionability, the regulations indicate that factors to be considered include whether an interest rate is 10 percent above the Wall Street prime rate, or 20 percent.

* Prohibiting the advertisement of various inducements such as use of the words "immediate approval" of loan applications or "immediate closings;" the regulations also prohibit the advertisement of a "no points" mortgage loan when that is not the case.

* Severely restricting the use of certain other inducements such as "bad credit no problem" and "avoid foreclosure." Lenders and brokers cannot use these terms in advertisements unless they fully disclose all the restrictions that may apply to such loans. In addition, brokers and lenders who use such inducements must provide the following warning: "You may lose your home if you cannot make all of the payments or if you miss any of the payments on this loan."

A number of organizations assisted in the development of these regulations, including the Massachusetts Bankers Association and the Massachusetts Association of Mortgage Lenders and Brokers.

C. Legislation to Regulate Home Improvement Contractors

The Attorney General played a major role in working with the Legislature to secure passage of the new law regulating home improvement contractors. The law enacted includes several important provisions which will:

* Prohibit home improvement contractors from also acting as mortgage brokers or lenders in connection with the home improvement contracts they enter into;

* Require contractors to register with the Commonwealth's Bureau of Building Regulations and Standards;

* Require a written contract between a contractor and a homeowner for any job over $1,000, detailing the work that needs to be completed and the terms of the agreement;

* Establish a Guaranty Fund to provide limited restitution to consumers who have been defrauded by a registered contractor but are unable to collect on the judgment; and
* Provide for criminal penalties for home improvement contractors who fail to obtain a certificate of registration.

D. Foreclosure Assistance

In response to the widespread incidence of foreclosures related to home improvement and mortgage schemes, the Attorney General, in June, 1991 called for and received extensive cooperation from over 100 lenders in a voluntary 120-day moratorium on foreclosures. After initiating this voluntary moratorium, the Attorney General's office supported the passage of a mandatory moratorium which was enacted by the Legislature. The Attorney General's office worked with private bar counsel and Registers across the state to enforce the moratorium.

In addition, the Task Force provided emergency assistance to individuals facing immediate foreclosure. As a result of this assistance, hundreds of foreclosures were delayed or cancelled. In those instances where it was not possible to stop a foreclosure, consumers were referred to appropriate social service agencies for assistance.

VI. Conclusions and Recommendations

As a result of its 18 months of work in the home improvement and second mortgage arena, the Task Force has reached the following conclusions and makes the following recommendations:

A. Conclusions:

* The unregulated and unlicensed mortgage broker and lender industry was unable to police itself to restrain adequately unscrupulous lenders and brokers from unfair and deceptive practices in the provision of second mortgage lending services.

* Entire communities abandoned by mainstream financial institutions are attractive prey to high pressure and illegal tactics by unscrupulous lenders and brokers in the provision of second mortgage products.

* Vulnerable and unsophisticated consumers need to be educated to the dangers of urban economic violence that can accompany equity-based financing.

B. Recommendations:

* Lending associations should establish rules of conduct and codes of ethics for members and discipline those who breach such rules and codes.

* Consumers in low income neighborhoods need greater access to more branches in low income communities. Financial institutions need to create innovative credit products for these communities, and must aggressively market these and traditional products to low income consumers.

* In fulfilling their Community Reinvestment Act responsibilities, mainstream banks should actively reach out to low and moderate income, minority and non-English speaking consumers. There is a compelling need for banks to become more "user friendly" to low and moderate income communities all across Massachusetts.

* In particular, banks should develop mortgage loan programs that are maintained in their portfolios so that more liberal and more flexible lending criteria can be applied to low and moderate income applicants. Mainstream financial institutions should expand second mortgage and equity based lending programs, with appropriate safeguards, so that more such lending can be made available to low and moderate income consumers.

* Banks should formulate long-range plans to include branches, loan production centers and automated teller machines in low and moderate income neighborhoods. Access to banking services is an essential part of modern life, and it is as necessary as telephone, gas or electric utility services.

* Mainstream banks should examine and scrutinize their financial relationships to other lenders that provide credit in low and moderate income

and minority neighborhoods. Banks must look at the impact of the mortgage companies they finance on affordable housing and gentrification. Financial institutions must make sure that the mortgage companies which they finance are lending on terms that are fair and that such terms are not unconscionable. Mainstream banks must avoid financing high-rate equity-based lenders.

* Second-mortgage lenders' and brokers' associations should aggressively police themselves consistent with the Attorney General's consumer protection regulations and with the Commissioner of Banks licensing regulations.

* Public schools and community organizations must expand consumer education programs so that consumers fully understand the fundamental terms of basic financial transactions. At a minimum, each graduating student should understand the concept of interest and credit, and the basic elements of a mortgage transaction.

* Public institutions and agencies need to monitor newly-adopted regulations to insure that they are effective in curbing past home improvement and mortgage abuses. They likewise need to enforce aggressively compliance with the new mortgage licensing and home improvement statutes.

The problems that created the second mortgage scandals are complex and cannot be eradicated overnight. However, the recommendations outlined in this report, if adopted and carried out by mainstream banks, second mortgage lenders, brokers, communities and public agencies, are a necessary first step to changing the urban economic landscape from one of deprivation and disintegration to one of hope and opportunity. The equity-based lending that was carried out under unconscionable terms and conditions by irresponsible businesses is just one form of urban economic violence that we must seek to prevent. But, only by aggressive vigilance, and the availability and access to products to meet the needs of the consumers who were targeted can the remedial process begin. And it is the responsibility of all of us.